Special Report
— U.S. Business Investment

Steve Malyon (416) 863-7719
stephen_malyon@scotiacapital.com

December 16, 2005

Improved Fundamentals Underpin Investment Outlook

Business investment has been strong in recent years. Its 8½% annualized growth rate since Q1 of 2003 was more than twice the pace of the rest of the economy. Consequently, business investment contributed more than 35% to real GDP growth during the period — double its share of output. Corporate profits have been growing at an even stronger pace — some 13% (annualized) on a pre-tax basis since Q1 of 2003, according to national accounts data. Corporations have been restructuring their balance sheets, raising dividend payouts and repurchasing shares. Now, there is increasing momentum for companies to "go for growth" by investing even more — a widely-followed survey of fund managers recently found that half want to see greater capital spending by businesses (a record high).

This report reviews some of the pros and cons that will influence U.S. business investment going forward. Activity is expected to remain strong through early 2006, after which a slowdown in consumer spending should cause businesses to tap lightly on the brakes. However, the lengths to which businesses have gone to fortify their balance sheets leave them well positioned to resume a strong pace of investment once the household sector's imbalances have been addressed.

The Pros

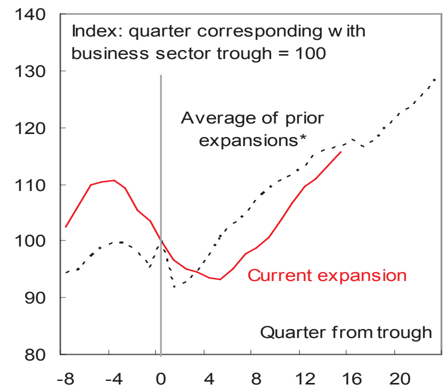
Economic Growth Still Solid

The U.S. economy has proven very resilient, particularly so considering the damage wrought by Hurricane Katrina. The 'soft patch' this spring proved temporary, although it was worrisome at the time for businesses, which managed their inventories carefully through the period and might have delayed some projects while assessing the situation. This appears to be giving way to a re-acceleration of activity. Recent near-term indicators of business investment have looked healthier — on a 6-month annualized basis, unfilled orders for core capital goods rose almost 11% in October — close to their fastest pace in more than a year. Following a decline through the middle of the year, capital spending plans by small businesses perked up recently, according to the National Federation of Independent Businesses. The repair of hurricane-damaged oil & gas extraction and refining infrastructure in the south is also supportive for the near term outlook.

Signs of Strength Abroad

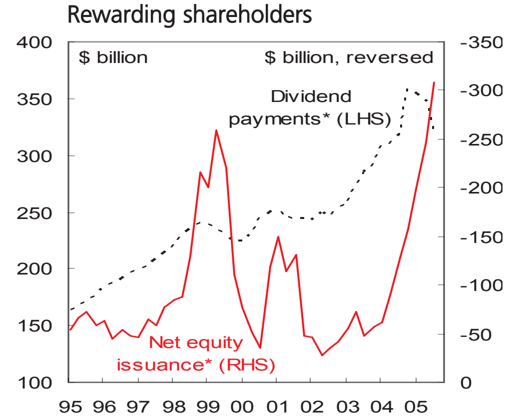
U.S. exports of industrial supplies have grown at a 15% annualized pace over the past 1½ years, while exports of capital goods such as industrial and business equipment have grown in excess of 10%. Steady growth in a number of emerging markets and improved economic prospects in Europe and Japan should help to maintain strong growth

Business investment — back to normal?



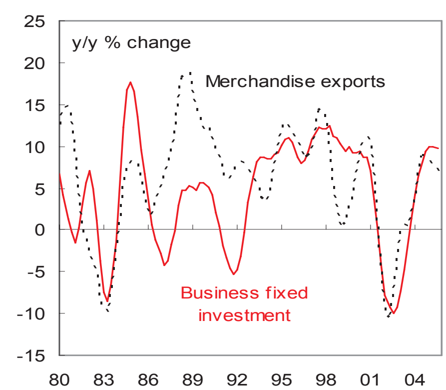
* Post WWII (excluding first half of early '80s double-dip).

Rewarding shareholders



* Non-financial corporations.

Strong growth abroad is encouraging for the outlook



in U.S. exports, encouraging businesses to expand capacity. The ISM manufacturing export orders index jumped to 59.2 in November — the highest level in 1½ years. Our expectations for a resumption of the U.S. dollar's decline next year will also boost U.S.-based exporters' competitiveness.

Restructured Balance Sheets

From a balance sheet perspective, businesses appear well positioned to invest at a stronger rate. Debt as a share of the net worth of non-financial corporations fell to its lowest level in Q3 since the late 1980s. Moreover, short-term instruments account for less than 30% of non-financial corporations' credit market debt, compared with almost 40% at the start of the decade. Financing costs are also relatively low. Corporate credit spreads remain tight, while a net share of respondents to the Fed's senior loan officer survey continued to trim spreads of commercial and industrial loan rates over their cost of funds, citing rising competition from other lenders as the primary reason.

Temporary Tax Provisions

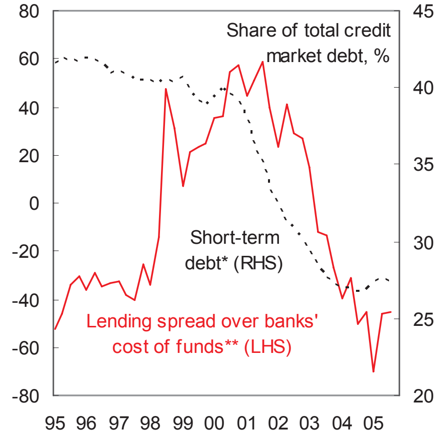
While temporary tax provisions can complicate an accurate assessment of the underlying strength of business investment, the near term implications of two such provisions appear positive. Part of the likely explanation for the modest slowdown in business investment in equipment & software early this year is that some activity was brought forward into 2004 to take advantage of accelerated depreciation schedules that expired in January. An unwinding of this effect should be supportive.

Business investment could also receive a lift from the deployment of proceeds from the tax holiday offered on repatriated foreign earnings included in the American Jobs Creation Act of 2004. Qualifying companies must avail themselves of the provision by the end of their respective 2005 fiscal years. Private-sector estimates of the total amount of earnings that have already been repatriated stand in excess of $200 billion, compared with annualized business investment in equipment & software of about $1 trillion in Q3.

Capacity Utilization is Rising

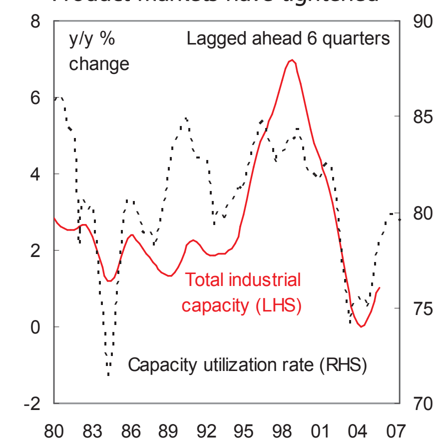
The industrial capacity utilization rate stood at a little over 80% prior to hurricane season — still 2% below its average for the 1990s but a considerable improvement from the sub-75% levels probed as the economy pulled out of recession in 2002. Normally, a significant tightening of utilization rates is followed by an increase in capacity. However, it is difficult to say just how supportive a factor this will be in the near term. Capacity in the non-durable goods sector continues to contract, with particular weakness evident in such industries as textiles and apparel. Given the cost-effectiveness of moving capacity in these sectors overseas, the prospects for a strong rebound would seem low. Moreover, much of the improvement in the durable goods manufacturing sector in the past two years has been due to the Japanese-led expansion in the auto sector. The restructuring of facilities by domestic automakers should provide support to business investment moving forward; however, we expect that new investment by Japanese automakers will slow. On the bright side, labour markets have tightened, capacity in the high-tech sector has been growing smartly, and high energy prices should encourage an increase in refining capacity and an expansion in the country's LNG import infrastructure.

Balance sheets are strong

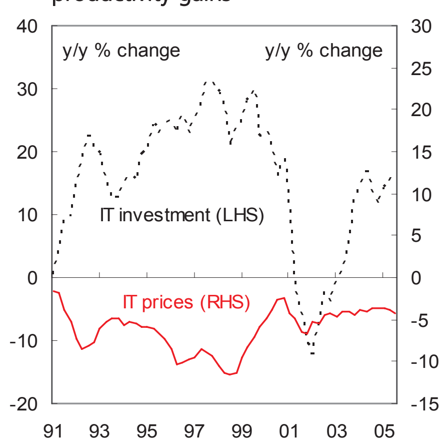


* Non-financial corporations.
** Source: Fed Senior Loan Officer Survey. Net share of banks increasing spreads on commercial and industrial loans to large- and medium-sized firms.

Product markets have tightened



Companies continue to pursue productivity gains



IT Investment Remains Strong

Investment in information processing equipment & software has been very strong in the past two years, rising at a 17.4% y/y pace in Q3 — the fastest since Q4 of 2000. It is unlikely to accelerate to the heady pace of the late 1990s, when Y2K preparations boosted outlays and relatively steep declines in prices for IT equipment & software lowered the cost of capital and encouraged investment. Nevertheless, companies' efforts to achieve productivity gains continue to pay off. Output per hour of non-financial firms rose 4.7% y/y in Q3 — well above its historical average. In fact, the 5.8% y/y gain in Q2 was the fastest in thirty years.

The Cons

Consumer Spending is Expected to Slow Next Year

The most compelling arguments in favour of a deceleration in business investment next year are cyclical. The economic headwinds facing consumers have strengthened, and should become increasingly evident next year, particularly if recent signs of a slowdown in housing markets are prophetic. Traditionally, business investment follows consumer spending trends with a very short lag. Businesses are no doubt concerned over the prospects of a consumer slowdown considering the degree to which consumers have supported the current expansion. As a share of GDP, consumer spending rose dramatically at the start of the decade to its highest on record, where it remains. Even more worrisome, outlays for discretionary, interest-rate sensitive durable goods have accounted for the increase.

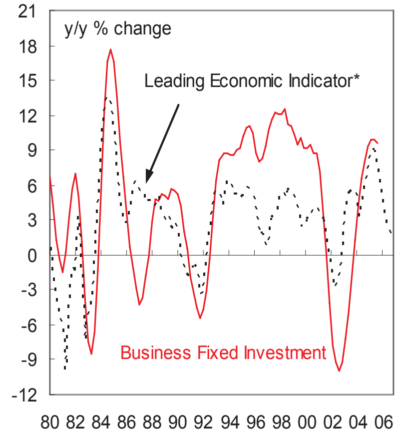
Profit Cycle Appears to be Rolling Over

Once growth in corporate profits begins to slow, the pace of business investment has always followed. Corporate profit growth appears to have rolled over from its cyclical highs. Pre-tax profits fell 12.8% q/q (annualized) in Q3, their first decline in a year. Hurricane damage and the associated insurance payments accounted for much of the weakness; however, margins fell for the first time in 2½ years, supporting anecdotal evidence that has been mounting for some months that businesses are having difficulty passing rising input prices along to their consumers. Absent a re-acceleration in productivity growth, rising input prices should continue to pressure margins, which remain well above historical norms.

The Financing Gap is at a Record Low

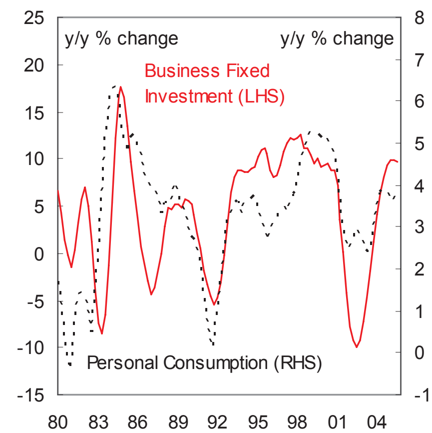
Normally, aggregate capital expenditures by non-financial firms outstrip cash flow, resulting in a positive financing gap that companies fill by raising external funds. The financing gap fell below zero in 2002 as companies undertook efforts to repair their balance sheets in the wake of the recession, but rose firmly back into positive territory by late 2004. However, the financing gap fell back into negative territory in Q2 of this year, and then plunged to a record low in Q3. Moreover, the Fed's latest senior loan officer survey shows that among the businesses that are utilizing external sources of funding, fewer are identifying new investment as the reason for doing so. Perhaps there is not a significant reservoir of profitable investment opportunities that has remained untapped for lack of available funds (throwing into question just how much additional investment

Leading indicators point to a slowdown

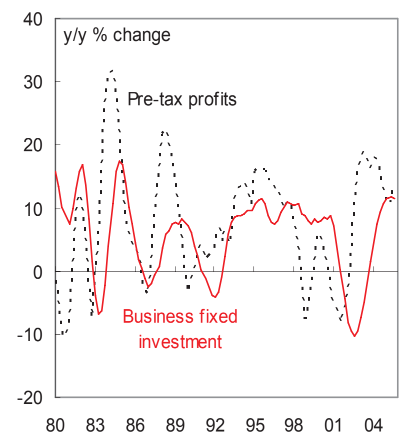


* Lagged ahead one year.

The economy's reliance on the consumer causes concern



Business investment reacts to the profit cycle



the aforementioned repatriation flows will generate). Alternatively, some companies could be keeping their powder dry due to the mounting pressures of paying for retiree benefits, for example.

Business Confidence has been Slipping

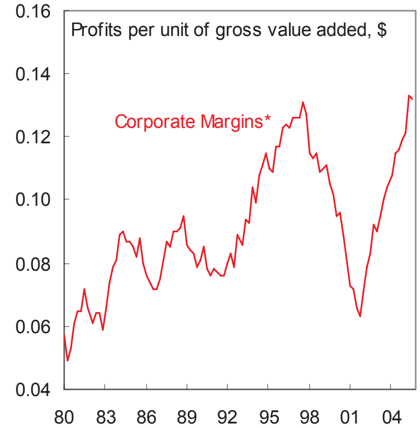
If the negative financing gap is a manifestation of slipping business confidence in anticipation of a more challenging environment next year, the implications for business investment are negative. The Conference Board's measure of CEO confidence has proven a reliable leading indicator of business investment trends in the past. This index touched its lowest level in almost four years in Q3. While recent upbeat readings on the economy and the decline in oil prices have probably lifted businesses' spirits since the survey responses were collected, the Q3 decline continued a deterioration that began 1½ years ago.

Conclusion

Our forecast calls for annual growth in business investment of about 9% this year — virtually no change from the 9.4% pace of 2004. The slowdown in business investment we anticipate during the second half of 2006 is expected to yield annual growth of 8% next year. However, with consumer spending expected to slow, business investment should account for a larger share of real GDP growth in 2006.

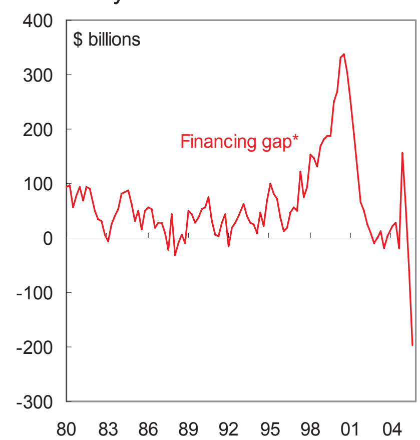
Expectations that the consumer and housing sectors cannot maintain their above-trend growth have likely fostered a relatively cautious attitude in some executive suites. However, due to the efforts undertaken to shore up corporate balance sheets in recent years, companies should be well positioned to invest at a strong pace once these imbalances are redressed. The pursuit of further productivity gains amid intense competition from abroad and the adoption of energy-efficient technologies in an era of high prices are two more factors that should provide ongoing support.

Anecdotal evidence suggests margins are peaking



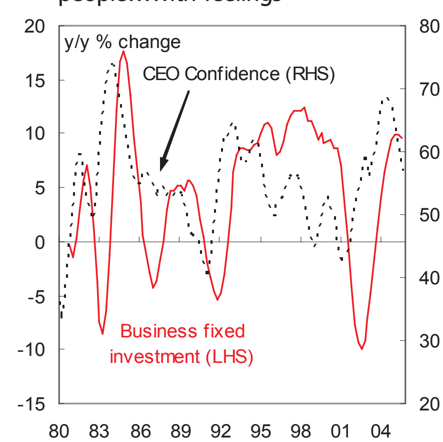
* Non-financial corporations.

Negative financing gap a sign of worry?



* Non-financial corporations.

Investment decisions made by people…with feelings



Scotia Economics
Scotia Plaza 40 King Street West, 63rd Floor
Toronto, Ontario Canada M5H 1H1
Tel: (416) 866-6253 Fax: (416) 866-2829
Email: scotia_economics@scotiacapital.com